Insider Trading involving Family, Friends and Rival Firms

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Jack L. Warner, the media mogul, once jokingly told Albert Einstein that he had his own theory of relativity: "Never hire a relative!" India's insider trading laws mandate that insiders follow this theory. The SEBI (Prohibition of Insider Trading) Regulations, 2015, make it illegal for insiders possessing unpublished price sensitive information (UPSI) about their company to profit from trading in its securities, either directly or through their relatives. The belief behind this rule is that benefiting a family member is akin to benefiting oneself. For this reason, the Securities and Exchange Board of India (SEBI) deems certain close relatives of insiders as insiders themselves. Recently, SEBI has expanded the list of relatives to cover a person's spouse and both their parents, siblings (and their spouses), and children (and their spouses).

These deemed insiders need to be extra careful while trading in the securities of publicly listed companies in which their relatives are employed, as such trades are presumed to have been undertaken based on UPSI held by the insider. Essentially, the law presumes that the insider in possession of UPSI would have tipped off the family member. Although this presumption of guilt is rebuttable, it requires them to provide evidence to disprove it. Failure to do so may result in both being held guilty of insider trading.

Unlike relatives, an insider's friend is not deemed to be an insider. In such cases, it is SEBI's job to demonstrate that the insider shared the UPSI with the friend, who subsequently traded based on that information. An illustrative example is a recent SEBI order dated January 31, 2025, in which it ordered an insider's friend to disgorge the illegal gains made by him from trading in the Infosys scrip. The alleged facts of this case are that two employees became friends while working at Wipro. Their friendship continued after one of them joined Infosys, a competitor of Wipro. While at Infosys, the employee came into possession of UPSI that Infosys had secured a strategic partnership with Vanguard. He tipped off his friend, who was still working at Wipro. The friend went ahead and traded in the Infosys scrip, thereby making a huge profit.

SEBI relied on the call records of both the insider and his friend to connect the dots. It found that after the Infosys employee had gained the UPSI, he had called his friend at Wipro and spoken to him for over twenty minutes. Just a few minutes after the call ended, the friend started placing orders in the Infosys scrip. SEBI also found that after the inside information about bagging the contract was publicly announced, the friend started selling and made a large profit on a relatively small investment. Another piece of evidence that SEBI used to build its case was the friend's unusual trading pattern; he took relatively small trading positions in Infosys and other scrips, making his activities during that period notably inconsistent with his usual trading activity.

An interesting question that arises from this case is: what if the Infosys employee, who possessed UPSI about Infosys bagging the contract, had himself traded, but in the Wipro scrip — not the Infosys scrip. Would such a trade by an insider in a rival company's publicly traded securities implicate the insider trading laws? The answer is yes, if one considers a novel theory of insider trading pioneered by the U.S. Securities and Exchange

Commission (SEC) called "shadow trading." Unlike traditional insider trading, this theory suggests that insiders can utilize UPSI related to their own companies to trade in the stocks of rival firms within the same industry. The concept is seemingly rooted in the belief that "a rising tide lifts all boats," implying that when a company's inside information becomes public, it can benefit the entire industry by raising the stock prices of both the company itself and its competitors.

In the notable case of *SEC v. Matthew Panuwat*, the SEC successfully prosecuted Matthew Panuwat (Panuwat) for shadow trading. Panuwat, who was employed at Medivation, a U.S. biopharmaceutical company, received inside information about Pfizer's potential acquisition of Medivation. Minutes after acquiring this confidential information, he bought call option contracts of Medivation's competitor, Incyte, which was also engaged in the biopharmaceutical business. Following the public announcement of the acquisition, Incyte's stock price rose, allowing Panuwat to profit from the trade. The SEC charged Panuwat for trading in Incyte's stock using Medivation's confidential information. A jury found Panuwat liable for insider trading last year. A significant factor supporting the SEC's case was Panuwat's agreement to Medivation's insider trading policy, which prohibited personal gains from dealing in securities of both Medivation and its competitors during his employment. Despite its success, many U.S. commentators have criticized the SEC's enforcement action, claiming that the SEC has stretched its insider trading reach beyond recognition by adopting such a novel theory. The U.S. Court of Appeals for the Ninth Circuit is expected to hear the case later this year. Should the Ninth Circuit uphold the Panuwat judgment, it would significantly broaden the scope of insider trading liability.

Whether SEBI will adopt the shadow trading theory in India remains to be seen. The likelihood appears slim because, unlike in the U.S., where insider trading law is based on a general anti-fraud statute, India has a distinct legal framework prohibiting insider trading in the securities of publicly listed companies. This framework specifically forbids insiders with UPSI from trading in the securities of the concerned company, not its competitors. Consequently, it appears improbable that SEBI would pursue a theory prosecuting insiders for trading in the securities of an unrelated rival company, especially when they lack UPSI about that company.

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